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ARIZONA CORPORATION COMMISSION
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W-00000C-06-0149

Dear Water Company Representative:

In connection with the Arizona Corporation Commission's ("Commission" or "ACC") evaluation of the regulatory impacts of non-traditional financing arrangements by water (including wastewater) utilities and their affiliates, Staff is soliciting comments from any interested party to the questions presented below. Respondents are requested to propose the appropriate regulatory treatment, along with the specific rationale (legal, accounting, etc.) for each of the suggested non-traditional financings. Please describe any assumptions used to support the proposed regulatory treatment.

Responses to Staff's questions should be sent to Docket Control on or before June 23, 2006.

STAFF'S QUESTIONS

1. What is the preferred regulatory treatment for each of the following financing arrangements?
 - A. A developer purchases a non-regulated parent company's non-voting stock. Each of the non-voting shares has a par value of \$1.00, is not eligible for dividends, is partially refundable and can be repurchased (subject to certain conditions) by the non-regulated parent for one cent (\$0.001). See attached diagram at Exhibit A. The parent company subsequently contributes the funds to an ACC regulated subsidiary water utility as additional paid-in capital.
 - B. A developer purchases a regulated utility's non-voting stock and that utility invests those funds in plant. The utility records equity for the proceeds. Neither refundable advances in aid of construction nor contributions in aid of construction are recorded.
 - C. A developer or a Municipal Government pays a fee for services provided by a non-regulated parent company for services typically covered by "Off-site Hook-up Fees" collected by regulated water and wastewater utilities. Then the parent company invests the proceeds in the regulated utility which is recorded as equity by the utility.
2. What is the maximum percentage of refundable "Advances in Aid of Construction" ("AIAC") appropriate as a percentage of total capital for a private or investor owned water utility?
3. What is the maximum percentage of non-refundable "Contributions In Aid of Construction" ("CIAC") appropriate as a percent of total capital for a private or investor owned water utility?
4. What is the most appropriate and most economical capital structure for a "new" water or wastewater utility?

Sincerely,

Ernest G. Johnson
Director
Utilities Division

EGJ:JJD:lhmc/CCK

cc: Docket Control Center (13 copies)

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AZ CORP COMMISSION
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June 23, 2006

Ernest Johnson
Director of Utilities
Arizona Corporation Commission
1200 West Washington
Phoenix, AZ 85007-2927

Re: Comments regarding non-traditional financing arrangements by water utilities
and their affiliates. (Docket No. W-00000C-06-149)

Dear Mr. Johnson:

Thank you for allowing water companies throughout the State to comment on the questions identified in your June 2, 2006 concerning certain non-traditional financing arrangements and issues regarding contributions, advances and capital structure for "new" water and wastewater utilities. Our comments are as follows:

Background.

All of the stock of Valencia Water Company (and four other Arizona water companies) is owned by West Maricopa Combine, Inc. ("WMC"). While Valencia is a regulated public service company, WMC is not. None of the water companies owned by WMC is a Class A utility.

Valencia is facing explosive growth (as are some of the other water utilities owned by WMC). Valencia is therefore facing the issues associated with financing significant expansion of its plant in order to accommodate new growth. Additionally, it is being required to raise and invest hundreds of thousands of dollars in treatment facilities to many of its wells require treatment to meet the arsenic standard. The cost of meeting this unfunded federal mandate is significant in relation to the existing revenues generated by these systems.

Preferred regulatory treatment

A general question that staff did not ask is: "Why would the entities try these non-traditional financing methods?" If returns on equity investment adequately compensated investors would non-traditional financing still be pursued? Would the level of equity investment be increased? According to the testimony sponsored by staff in rate proceedings, the rate of return being provided water companies should be encouraging

direct investment in water companies. If equity levels are below the levels the Commission deems to be appropriate, those investing equity into the utility need to be rewarded with higher returns. Increasing returns, not setting artificial regulatory hurdles is the appropriate means of addressing the issue.

- A. Valencia understands that investment in a non-regulated parent is generally beyond the jurisdiction of the ACC. Activities of the parent should not become regulated by the Commission simply because the monies raised by the parent may, at the parent's discretion, be invested in a utility affiliate. A possible exception may exist where the non-regulated parent utilizes the monopoly power of the regulated affiliate to extract monies from someone (usually a developer). The hypothetical posed in A raises this issue. From the facts presented, no benefit is received for the investment being made. Not only is the investor precluded from voting and receiving dividends, its investment can be unilaterally returned at the rate of one cent for every dollar invested. If the Commission, after hearing, concludes the investment was a sham, then the dollars received at the utility level should be treated exactly as if the dollars were paid directly to the utility by the developer/investor. On the other hand, if the parent is providing value for the investment dollars that is not dependent upon an action of the utility affiliate, the dollars received by the utility from the parent should be treated the same as any other paid in capital.
- B. The fact that the stock is non-voting and that funds received by the parent may ultimately reach a regulated utility should not subject the parent to the ACC's jurisdiction. The Commission must recognize that non-voting stock is used in the investment field throughout the country. Again the question should be whether the developer/investor is receiving a benefit other than service from a regulated utility (e.g., the right to participate in the proceeds if the parent is sold; the right to sell the stock to third parties; the access to unregulated services provided by the parent). If so, the monies paid to the parent and invested in the utility affiliate should be treated as paid-in capital. If not, the monies should be treated the same as if the utility received the funds directly from the developer/investor.
- C. The hypothetical assumes the fee paid to the parent is "for services typically covered by 'Off-site Hook-up Fees collected by regulated water and wastewater utilities.'" If this is true, and if those services are "regulated services," then, as stated above, the fees should be treated the same as if paid directly to the utility. However, services such as engineering, construction and master planning, while recoverable as a prudently incurred cost if performed or secured directly by a regulated utility, are not within the type of service regulated directly by the ACC. (Certainly the Commission does not regulate the fees charged by engineers and attorneys). Therefore, simply because a utility could request an Off-site Hook-up Fee be established that might include costs associated with a

particular service, it does not mean the parent is subject to regulation if it performs the service directly.

Parent companies are now being required to expend money to provide master plans, financing and larger and more complex assets than a "Off-site Hook-up fee" was meant to cover. In today's environment government agencies such as the Maricopa County Planning and Zoning Department are requiring master plans for water and sewer and dry utilities that cover over 100 square miles in order for a developer to develop his one or two square miles. In addition this huge master plan requires larger facilities to be designed and constructed, which in Staff's approach to rate base is not "Used and Useful" for the actual subdivision being developed. The additional cost of master planning, design and construction of larger and more complex assets and the operation and maintenance of the master plan and the assets are not covered by the "Off-site Hook-up fees" and are a necessary expense in the development environment today. If a parent company decides to hire additional engineering, accountants and other staff either internally or through consulting contracts then the parent has the right to require developers to pay for this expanded service since the parent will not be reimbursed by the ratepayer through rates regulated by the ACC.

If a parent generates cash from unregulated outside activities, as described above, then any profits from that activity can be used for investment in a utility company and should be treated as paid in capital. There should not be arbitrary restrictions (regulatory barriers) placed on investment by a parent in its utility affiliate. Such a restriction would only serve to discourage investment.

Advances in Aid of Construction.

There should not be a maximum percentage of refundable "Advances in Aid of Construction" (AIAC) as a percentage of total capital for a private or investor owned water utility. To set a maximum of any kind is to transfer the developers' risk of development to the water utility without any corresponding reward for taking the risk. Water utilities have the developers pay for 100% of the cost of the facilities because the up front costs are enormous and the water utility does not know if that development will ever be successful, or if the return the utility will receive through rates will be sufficient to justify taking such risks directly.

A real life example – A developer put in a \$600,000 system in 2000 for a subdivision containing 182 residential lots. The system was appropriately sized for the approved and platted development. There was a need for the system as the subdivision had been approved and platted and lots were being offered for sale. As of the end of 2006 there were only 16 users in the system and the revenues generated do not cover the cost of operating and maintaining the system.

In this instance, the development was funded through advances. As a result, it is the developer's capital investment at risk, not that of the water utility (which is, however, operating this system at a loss). Had the water utility been required to make the investment directly due to an arbitrary ceiling on advances, it not only would be experiencing the operating losses associated with this system, but also would have \$600,000 of capital tied up in this losing venture. These funds would not be available for other purposes (such as installing necessary arsenic treatment or replacing worn out plant). Had the water utility invested these sums directly, it also would face the prospect that the ACC would conclude a portion of the plant is not "used and useful" or was somehow imprudent, when it seeks to raise rates to recover the investment in the system. This "regulatory" risk rises dramatically with the amount of rate increase involved.

The Commission should seriously consider the potential adverse consequences that can arise if arbitrary limits are imposed on the level of advances for water and sewer utilities. Rather than limiting AIAC, the ACC should be considering providing higher returns to encourage equity investment and setting rates that include dollars for reserves and capital improvement programs. The trend of disallowing all CWIP, even if it is in service before rates go into effect, and the use of a very rigid historical test year, only serve to encourage the use of advances as the primary means of funding new plant additions.

Contributions in Aid of Construction.

There should not be a maximum percentage of refundable "Contributions in Aid of Construction" (CIAC) as a percentage of total capital for a private or investor owned water utility. While on rare occasions a developer contributes plant up front, in most instances CIAC reflects either a relatively unsuccessful subdivision funded initially with AIAC or the Commission's decision to treat hook-up fees as contributions. In the former case, CIAC is created by moving the remaining portion of an AIAC to CIAC, meaning that the subdivision is generating insufficient "gross" revenues to return the base investment to the developer. High CAIC created in this manner is an indication that the original investment was marginal. If the utility makes the investment directly, it needs to be compensated by higher returns, meaning higher rates for customers.

The advent of hook-up fees is a recognition of the enormous up-front cost of installing water and wastewater systems today. The impact on the utility's CAIC balances is a combination of phenomenal growth and the ACC's decision to treat the fee as a contribution. Placing arbitrary ceilings on the amount of CAIC will only create hardships to utilities that are already being strained and increase water rates to customers.

Capital Structure.

There is no single capital structure that is both the most appropriate and the most economical for a "new" water or waste water utility. Where a utility is a true start-up, the ACC should seek to ensure the utility will have sufficient cash on hand to either hire directly or through subcontracts the operations staff and professionals that are necessary

to get the utility to a profitable status. The ACC's practice of requiring some form of security is reasonable.

In most instances "new" utilities are formed in connection with "new" developments. Therefore, the risk of the development may appropriately be placed on the developer by encouraging the use of AIAC, as the Commission has done in the past..

The reality is that the capital structure of water and sewer utilities is, for most purposes, meaningless until the utility has grown to a size that it can attract outside financing without the personal guarantees of the owners. At such point, lenders and investors will cause the utility to reach what is perceived in the financial community to be a well-balanced capital structure. Where a utility has no hope of securing outside financing, undue focus on the capital structure by the ACC is dangerous. For example, small utilities that have suffered operating losses year to year are subsidizing the customer's rates. However, on the balance sheet this translates into a negative retained earning. In reality, these sums represent a form of paid in capital (although reflected as a negative on the balance sheet). Setting a minimum equity level would effectively penalize the utility's investors for covering the operating losses of the utility.

Thank you for this opportunity to submit comments on these questions. We look forward to actively participating in this generic docket.

Very truly,



J. John Mihlik, President